$50.00 ANNUALLY
40 Letters Per Year

DOW THEORY LETTERS, INC.

"The Market as Interpreted under the Dow Theory"

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MILESTONES: In November, 1954, the Industrial Average (after 25 years of trying) hurdled their 1929 peak of 381.17. Currently (10 years after the 1954 surge) the Industrial Average is far above what once seemed the "insurmountable 1929 high".

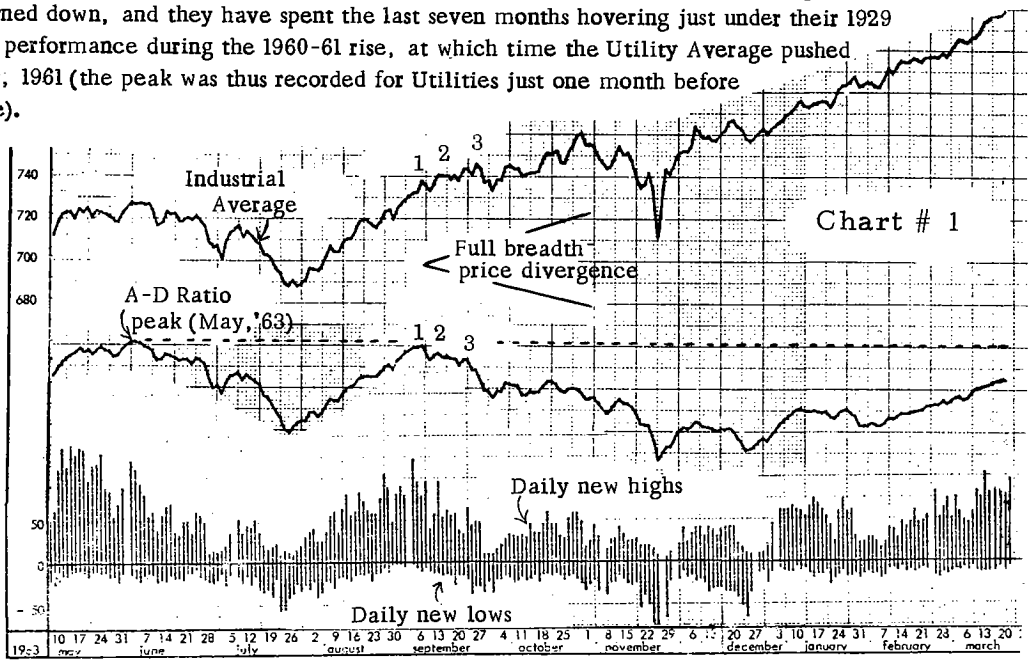
In February, 1964, the Rail Average (after a 35 year effort) pushed above its 1929 high of 189.11. In the month since then, the Rails have climbed 4 points above the record 1929 level.

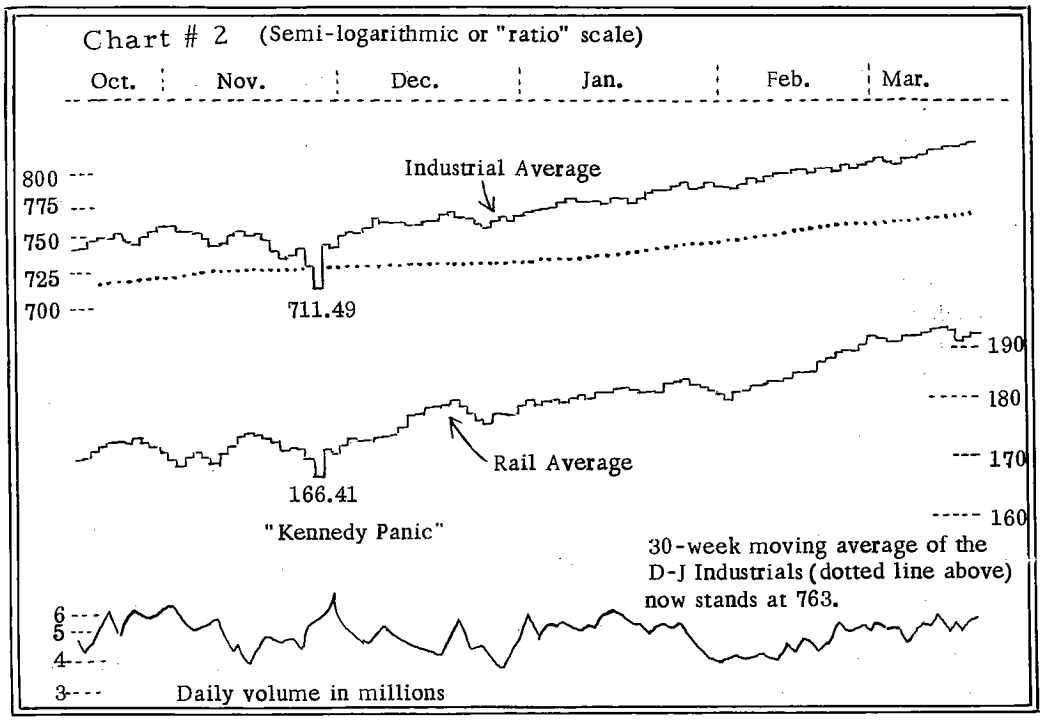
In August, 1963, the Utility Average (after 34 years of trying) rose to 144.37, two points above the 1929 record high close of 142.40. The Utilities immediately turned down, and they have spent the last seven months hovering just under their 1929 high. This is in sharp contrast to their performance during the 1960-61 rise, at which time the Utility Average pushed steadily up to a high in late-November, 1961 (the peak was thus recorded for Utilities just one month before the final peak in the Industrial Average).

* * * *

BULL FEVER: In the opening Letter (January 2) of this year, I "bet" that 1964 was "going to make up in drama and action for what 1963 lacked". As of this writing, the bet would seem to be a correct one.

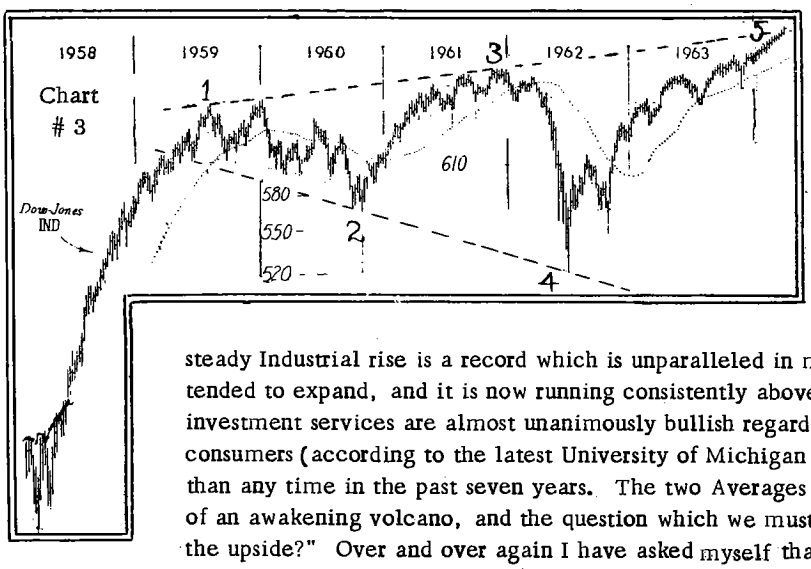
(1) Chart # 3 depicts a formation which has been discussed in many recent Letters. It is a huge five-point reversal pattern or "broadening formation", a structure which has been in the process of developing since 1959. As noted by Edwards and Magee ("Technical Analysis of Stock Trends"): "After studying the charts for some 20 years and watching what market action has followed the appearance of broadening price patterns, we have come to the conclusion that they are definitely bearish in purport — that, while further advance in prices is not ruled out, the situation is nevertheless approaching a dangerous stage." Later they note that "nine out of ten times they (i.e. broadening patterns) carry bearish implications." The broadening pattern which has now appeared in the price structure, however, would seem to belong to that rare group — the 10% which break to the upside. Over the past two weeks it has become apparent that the Industrial Average has pushed just beyond the "roof" of the broadening formation (point 5 on chart # 3). This means





that Industrials are now "free wheeling" above their last "restrictive" trendline, and at the same time they are pushing into all-time high territory.

(2) Taking the entire movement since 1949 as one massive post-war rise, the bull market first showed classic "third phase" characteristics during the 1957-60 advance (these characteristics were high volume, surging low-priced stocks, low yields, wide public participation, crowded board rooms, etc.). As seen on chart # 3, the current leg of the rise (which began in June, 1962) represents the third major advance since the 1957 lows. It is probable that history will label the entire structure since 1959 as an unprecedented three-part speculative "wind-up" (actually a three-part third phase) for the great post-war bull market. For without a doubt each of the major rises since 1957 contained well-defined third-phase speculative characteristics (for details see Letter 247).

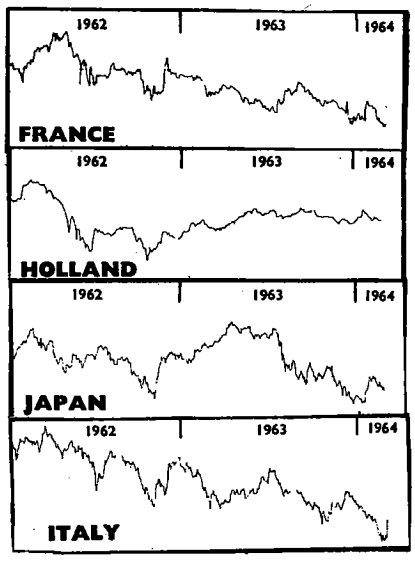


(3) The current advance has carried Industrials higher (except for a minor 7¢ decline during the week ending December 13) for sixteen consecutive weeks. No Industrial rise during 1957-59 or 1960-61 compares with this series, and, in fact, the sixteen weeks of steady Industrial rise is a record which is unparalleled in market history. Over the past few weeks volume has tended to expand, and it is now running consistently above 5 million shares per day. Newspapers, magazines and investment services are almost unanimously bullish regarding the business picture for the rest of the year, and consumers (according to the latest University of Michigan survey) are more optimistic on the business outlook than any time in the past seven years. The two Averages are pushing up with a persistency which reminds one of an awakening volcano, and the question which we must ask is: "Are we in the midst of a great 'blow-off' on the upside?" Over and over again I have asked myself that question. The answer: an "explosion" seems more of a possibility now than at any time since 1929 — but I believe that the market could turn with practically no warning (see Special Study), and that the danger is also the greatest since 1929.

(4) In the background, the shadow of the May, 1963, peak in the advance-decline ratio still looms. Without exception, in all other instances where the Industrial Average has continued to advance beyond a major peak established by the A-D ratio, those advances have been distributive in nature. Major peaks in the A-D ratio followed by extended advances in the Averages occurred in 1919, 1928-29, 1947, 1959-60, and 1961. In retrospect, advances in the Averages beyond peaks in breadth during each of these instances represented periods of important distribution. In 1959-60 and in 1961 industrial production was pushing to record highs and this generated great optimism for a continuation of the market rise then in progress. But the technical warning inherent in a breadth index which had already topped out proved to be a better forecaster than record industrial production, and the market subsequently gave back all of its gains.

Will the current ten-month rise in the Industrial Average beyond the May, 1963 peak in the A-D ratio prove to be something different? It could be, but after years of watching markets, I have become leery of betting on the unprecedented. And (at the risk of being labeled the stubbornest man alive) I continue to believe that the market is advancing on "borrowed time".

FOREIGN MARKETS: Periodically, I find it worthwhile to review the price action on the leading foreign markets. Recently, there have been many interesting movements which are not at all typical of "normal" times. As a rule, the markets of the Free World tend to move together. It is obvious from a study of the accompanying charts, however, that this is not the case at present.



The French market, after touching a bull market high in 1962, is now dropping to new lows (well below the lows of the Algerian crisis). The Dutch market recorded its peak in 1961, broke to a low in 1962 and has now flattened out after a sharp 1962-early 1963 rise. Japan's "people's market" established a bull peak as late as 1963, following which it broke badly. The Japanese market has now broken below its 1962 lows, and it is notable (some call it grotesque) that a group of Japanese businessmen and bankers have recently organized a giant "pool" in an effort to support the Japan Exchange. Latest news is that on March 17 Japan raised its discount rate to 6.5%. The Italian market has broken to a four-year low, and the profile of that average suggests that an important bear market is in progress. West Germany's average (not shown) touched a bull peak as early as 1960, then broke to a low in 1962. Since then it has staged a recovery of about 50%. Finally, the British market (not shown) struck a bull peak in early 1961, then dropped to a low in 1962 along with our own market. Following 1962 the English average rose to within about 5% of the old high (during late 1963). A sharp break in 1964 (see Letter 243) chopped 10% off the price of the British average. Over the past few months, the British market has been creeping upwards with little excitement.

CONCLUSION: None of the important foreign markets have been able to better bull market peaks established during 1960 to 1963. The U. S. alone has seen its Averages rise to new highs. On the face of it, I consider this a dangerous situation. (Charts courtesy of my friends at "The Investor", England's leading investment Service).

STOCK SELECTION: I have seen many references to technical analysis as "the lazy man's way out". One advertiser in Barron's, in fact, recently referred to technicians as "short cut artists who watch wiggly lines instead of fundamentals." There is probably more truth in these accusations than the average market student is willing to admit. Actually, technical analysis is the art of drawing conclusions from market action itself, rather than from a fundamental examination of values based on statistical research.

Personally, I am of the opinion that technical analysis may be of more use than fundamentals during periods of general market overvaluation or periods in which purchase of any stock entails a high degree of speculative risk (the present would be such a period). Projecting (a favorite pasttime of fundamentalists near the top of booms) can be particularly dangerous and deceptive, even if the projections are correct. I well remember the example of Trans-World Airlines during 1945-46 (the height of the airline boom). Many services were recommending TWF on the basis of projected airline revenue but the stock actually dropped from 79 in 1946 to 9 in 1948. Meanwhile, airline revenues did increase from $23 million in 1946 to $72 million in 1948! It was a matter of disastrous timing.

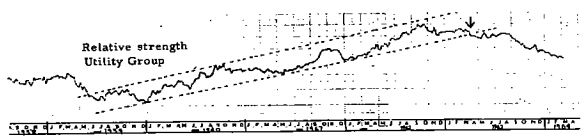
The next point is that I believe the average student follows a rather shallow approach towards technical analysis, and for this reason he is apt to find it unsatisfactory. When attempting to select a stock along technical lines, I ask myself the following question: (1) Is the market (i.e. the majority of stocks) in a rising trend? If the answer is yes, then the odds are at least 50/50 that my stock will go up rather than down. Obviously, when market breadth is in a declining trend, the odds are against the buyer, since at such times even a stock which is outperforming "the market" may be declining — but simply declining less than the market.

(2) Given a rising trend in market breadth, which groups are acting best? Personally, I prefer buying into a depressed group which is showing definite signs of reversing its declining R. S. trend. The chances of dramatic (percentage) appreciation are best and the risk of loss least in a group which has already sustained a great drop in popularity, but which is now gaining in popularity again. As an aid in identifying such stocks, this writer keeps monthly charts of 88 different stock groups. Each chart shows the actual group price and the group R. S.

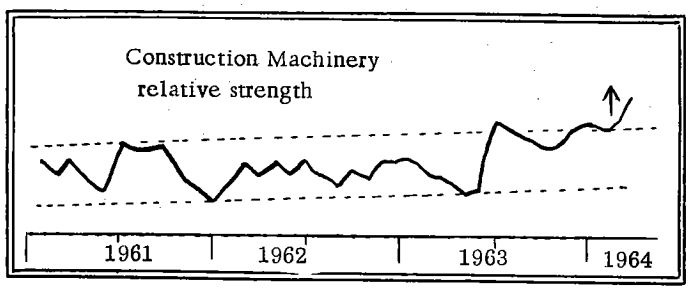
(3) I have found that the longer the time span covered by a chart, the more one is likely to see and the more valuable the chart. For this reason, after picking a depressed group which is turning up in R. S. , I then turn to monthly and weekly charts of the individual stocks in that group. These are the things that I look for in the charts: (a) does the stock have a substantial and lengthy base? Does the base take the form of a recognizable pattern such as a "rectangle" or "ascending triangle" (I always prefer stocks with definite patterns). (b) Are volume implications correct? (c) Has the R. S. line in the individual stock turned up with the group? (d) Is the stock far enough away from the last "supply area"? A stock which has dropped from 180 to 50 and then turned up is more attractive to me than a stock which has dropped from 60 to 50 and then reversed. In the latter case, there are apt to be many sellers only 10 points above the buying price of 50. (e) Is the stock above its 10-week moving average and is the 10-week moving average above the 30-week moving average? If not, it might pay to wait until such a relationship appears (see comments on Bullard, Letter 246). (f) Finally, what is the trend of the stock's short interest, and have there been any important secondary distributions in the stock? Information on these last two points can often prove valuable.

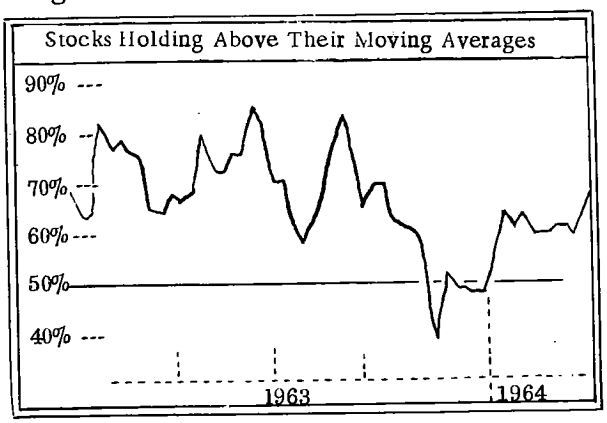
STOCKS: Of 432 representative issues which are tabulated at this office each week, 239 or 67% are now holding above their 30-week moving averages, a rise of 3% from last week. This study will remain bullish as long as more than 50% of the issues are above their moving averages. (Chart of this study on page 4).

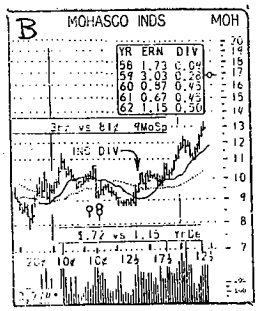
GROUP RELATIVE STRENGTH: A significant change has occurred in the R. S. of the Construction Machinery Group. After moving sideways for three years, the R. S. line of this Group has recently pushed out to a new high. This undoubtedly accounts for the strength in such previously depressed issues as Bucyrus-Erie. Of the six catagories of machine makers, this Group (construction) is by far the strongest in R. S.

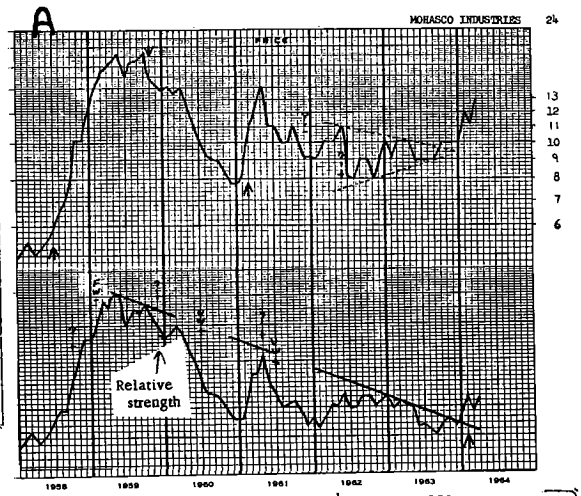


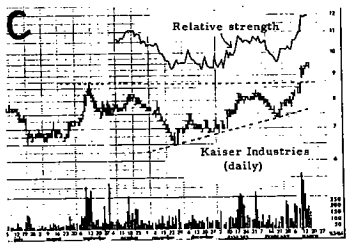
The Utility Group (perhaps due to rising money rates) shows an R. S. line which has now dropped to its lowest level since 1961. Something is wrong here, and I would avoid any stocks in this group and in the Natural Gas Group as well.

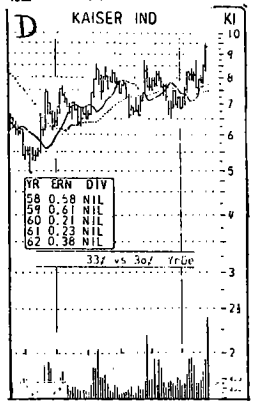










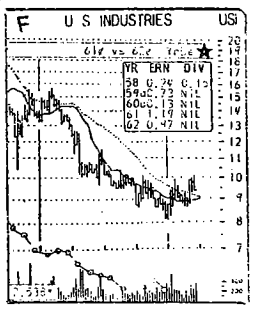


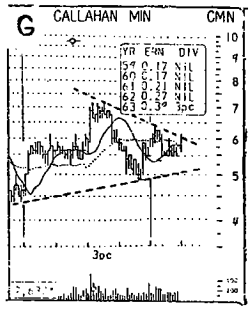
The investor should train himself to think in terms of appreciation or percentage of rise rather than of points gained. Thus the recent rise of 8 points (subsequently lost) in Telephone meant little in terms of real profits, but the 8 point rise in Bucyrus-Erie and the 6 point rise in Bullard following recent recommendations represented appreciation of better than 33%. It is probable that if the market advance continues much further, the lower quality (lower-priced) stocks will start moving. For this reason, I personally prefer them as a speculative trading medium. This does not mean any random low-priced issues: actually only a select number of secondary stocks appear attractive and ready to move at this time. This is in sharp contrast to 1959, for instance, when almost every low-priced stock was on its way up.

Mohasco (see monthly chart A) has been declining in price and R. S. since 1959. Late last year Mohasco pushed out of a large symmetrical triangle, and a few months ago this price action was confirmed by a reversal in MOH's five-year downtrend in R. S. The weekly chart (B) shows MOH's price holding above its 10-week moving average (solid line) and the 10-week average holding above the long-term or 30-week moving average (dotted line). The relationship of these three price indicators is bullish, and the stock is an attractive speculation at these levels.

Kaiser Industries has spent the last six months tracing out a large inverse "head-and-shoulders" pattern which in some ways (see daily chart C) resembles an ascending triangle. The stock broke out when it bettered the 8 3/4 level, and volume characteristics on the breakout were good. The weekly chart (D) shows the 10-week moving average at 7 3/4 just above the 30-week moving average at 7 1/2. This is an issue which should participate in any further rise.

U. S. Industries is now selling for about half its 1961 price. The daily chart (E) shows an inverse "head-and-shoulders" bottom with a potential breakout level at about 10 1/2. Chart F is a weekly of the same stock, and here we see the price rising above the 30-week moving average. The stock is interesting, mainly because there are so very few low-priced issues in potential head-and-shoulders reversal formations at this time. USI should be a good speculation if it can move above 10 1/2 on volume.





Finally, Callahan Mining in the low-priced group is worth studying. The stock is flirting with the idea of pushing out of a huge symmetrical triangle (chart G). This stock has been a good mover in the past, and I consider it one of the more attractive of the low-priced issues. CMN has been to the 9 area three times since 1956 — a definitive breakout here could easily take it to 9 or better again.

Chart #1, chart of Utility Group, and charts C and E courtesy of Traders Research, 1431 Pearl Ave., Alton, Illinois 62003.

Chart #3 and charts B, D, F, and G courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kan.

Chart A courtesy of Ray*Signals, 141 Broadway, N.Y.C. 6, N.Y.